Daiwa Capital Markets

Euro wrap-up

Overview

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- Stocks crashed and euro area periphery bonds saw a massive sell off as the ECB's policy response to the coronavirus crisis disappointed and Lagarde stated that it wasn't the ECB's job to close spreads.
- Bunds and Gilts struggled for direction but ended the day little changed at 10Y maturities.
- With the ECB wanting governments to provide the main response to the coronavirus, investors will want to see a plan for a coordinated euro area fiscal stimulus by the weekend.

Daily bond market movements

Bond	Yield	Change
BKO 0 03/22	-0.986	-0.011
OBL 0 04/25	-0.904	+0.019
DBR 0 02/30	-0.753	-0.005
UKT 0½ 07/22	0.210	+0.045
UKT 0⅝ 06/25	0.240	+0.033
UKT 4¾ 12/30	0.279	-0.017

*Change from close as at 4:30pm GMT.
Source: Bloomberg

Euro area

ECB finally unveils its coronavirus remedy

Following the 50bps cuts by the Fed and BoE, the ECB today finally agreed its first response to the coronavirus pandemic. And in certain ways, it appeared inadequate. For example, the Governing Council agreed unanimously to leave unchanged its main interest rates, including the -0.50% deposit rate and 0.00% refi rate. It also left unchanged its issue and issuer limits on its public sector asset purchases. Nevertheless, the ECB did announce a package of several other measures, with actions related to both monetary policy and financial supervision, including:

- New weekly longer-term refinancing operations (LTROs) to provide extra near-term liquidity support to the financial sector, with full allotment and an interest rate fixed at the -0.50% deposit rate. These will all mature on 24 June, and thus aim to meet banks' near-term liquidity needs before the TLTRO-III operation is held that month.

- More generous terms on the TLTRO III operations from June 2020 to June 2021. In particular, the maximum interest rate to be applied to these operations will be 25bps below the average refi rate applied over the period of the loans (i.e. -0.25% to start with). For banks that maintain their levels of credit provision, the interest rate will be lower, and as low as 25bps below the average deposit rate over the term of the loan (i.e. as low as -0.75% to start with).

- The maximum total amount that banks will be able to borrow under the TLTRO III operations was raised by 20ppts to 50% of their stock of eligible loans as at end-February, i.e. to about €2.9trn. In addition, an easing of collateral rules will be considered to try to maximize take up of the loans.

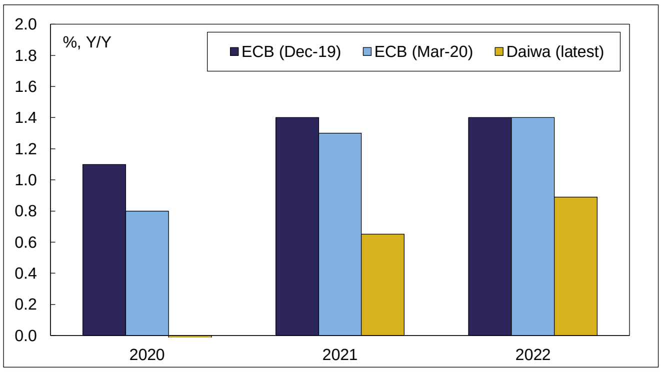
- A temporary increase in net asset purchases of €120bn until the end of the year, with a "strong contribution" from private sector asset purchases.

- Beyond the Governing Council, the ECB Supervisory Board decided to grant banks greater flexibility with respect to their capital and liquidity buffers, including allowing them to operate temporarily below Pillar 2 capital requirements. And it will consider further flexibility in the implementation of bank-specific supervisory measures too.

ECB not (yet) ready to do whatever it takes

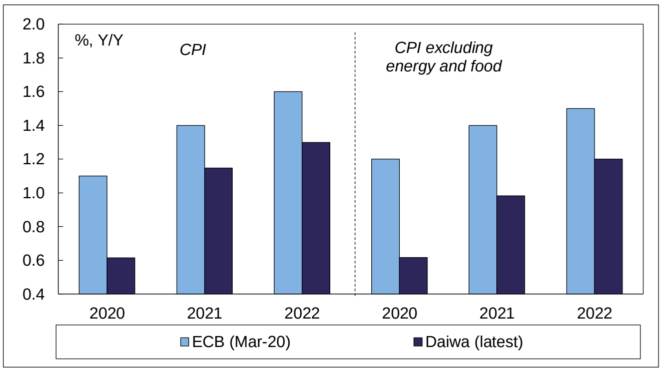
The financial market response to the package was highly unfavourable, with stocks falling sharply and yields on BTPs and other periphery bonds jumping markedly higher. Admittedly, the ECB did leave its forward guidance unchanged to keep open

Euro area GDP forecast: ECB* vs Daiwa



*ECB forecast finalised on 28 February.
Source: ECB and Daiwa Capital Markets Europe Ltd.

Euro area inflation: ECB* vs Daiwa



*ECB forecast finalised on 28 February.
Source: ECB and Daiwa Capital Markets Europe Ltd.

the door to further rate cuts. And in her press conference, Lagarde firmly stressed that the floor to rates (i.e. the so-called reversal rate) had not yet been reached. But the decisions to leave the main interest rates unchanged, and not to increase the issue and issuer limits on the public asset purchases, strongly suggested that, unlike in September, the hawks on the Governing Council had won the arguments this time around. Indeed, Lagarde stated in her press conference that it was not the job of the ECB to “close spreads”, adding fuel to the fire of the BTP sell-off. In a subsequent interview, she tried to rein back, stating that the ECB had scope to deviate from its capital key in purchasing assets and was mindful of fragmentation risks. But that gave only limited respite to BTPs. And, while the ECB still has some ammunition left, the overall sense was that the Governing Council is not (yet) prepared to do “whatever it takes” to tackle the impact of the coronavirus.

Fiscal policy now needs to do its bit

The ECB’s package will, however, provide some support to the private sector. The decision to cut the interest rate on the TLTRO-III operations without reducing the deposit rate means that indebted firms and households could benefit from lower rates without simultaneously penalising the banks. The significant increase in the amount of TLTRO-III funds available, coupled with easier collateral rules, should disproportionally benefit Italian and Spanish banks, which have typically drawn most funds under these operations. The two-thirds increase in monthly net asset purchases (on average an extra €13bn per month) is substantive, particularly given the emphasis on private sector securities – in recent months, the ECB has bought on average €4.5bn per month of corporate bonds. And the coordination between ECB monetary policy and the euro area’s financial supervisory functions is a marked improvement from the past – previously, monetary easing was neutered by regulatory tightening. Nevertheless, just as the UK managed to do yesterday, we now also need to see euro area fiscal policy-makers step up to the plate with a coordinated large-scale budgetary stimulus. But while the European Commission might well have plans for that, and Germany’s government is likely to downplay its balanced budget obsession for the time being, we doubt that the final fiscal policy response will be fit for purpose. And in the absence of a medical miracle, the euro area looks to be heading for deep recession. (The ECB’s updated economic forecasts, published today and shown in the charts, are already out of date and so way too optimistic.)

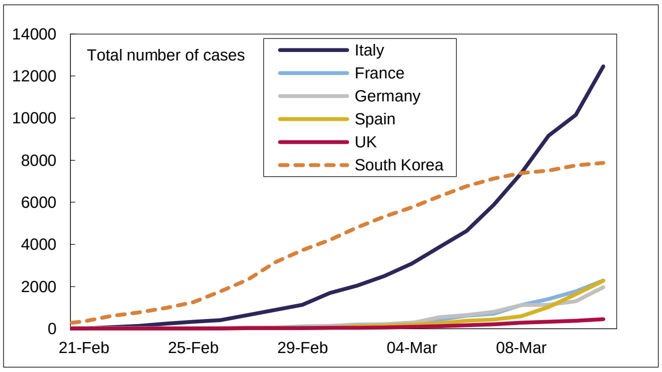
US and Italian curbs reinforce recession risks

Certainly, while the implementation details are still unclear, yesterday’s decision of President Trump to ban for at least thirty days entry to the US from ‘aliens’ who have spent any of the 14 days prior to arrival in the 26 countries of the Schengen area (including all euro area member states bar Ireland) was a major blow to the ailing aviation industry. Germany, France and the Netherlands alone accounted last year for more than 140 flights a day carrying 35k passengers to the US. And the ban represents a further impediment to trade more generally. However, controls on domestic activity imposed by member state governments will be more costly, as illustrated by last night’s extension of the Italian lockdown rules. In particular, all retailers, except food stores, tobacconists and pharmacies, now have to stay closed, as do cafés and restaurants. Other businesses are permitted to continue to operate, but their output will be hit by impediments to both supply and demand. And with retail, wholesale, hospitality and recreation activities accounting for more than 17% of Italian GVA, it is inconceivable that GDP will not fall sharply in both Q1 and Q2.

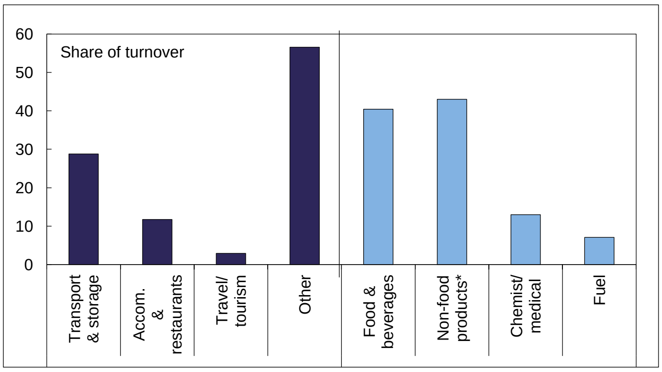
IP jumped at the start of the year

For the record, the economic dataflow today continued to suggest a stronger-than-expected start to the year for activity before the coronavirus shifted everything into reverse. Euro area industrial production in January beat expectations with a rise of 2.3%M/M, the most in more than two years. It was already known that all of the large member states saw a stronger start to the year in this respect. And today’s data confirmed that, at the euro area level, all major categories – capital, intermediate and consumer goods – registered an increase in output. Machinery (up 4.6%M/M) and chemicals (2.9%M/M) were among the stronger performers. In contrast, however, production of motor vehicles fell back again, dropping 0.6%M/M to the lowest level since August 2014.

Europe: Coronavirus cases in selected countries



Euro area: Share of services and retail turnover



Source: WHO and Daiwa Capital Markets Europe Ltd.

But contraction likely in Q1 and Q2

Of course, the increase in production in January followed a marked drop of 1.8%M/M in December. And so, IP was still down 1.3%3M/3M at the start of 2020. While surveys point to a further improvement in underlying momentum in February (e.g. the euro area manufacturing output PMI rose to a nine-month high last month), supply-chain disruption and weaker demand seem bound to weigh on production in March and coming months. So, following three successive quarters of negative IP growth through to Q4, further contractions in the sector in Q1 and Q2 seem a decent bet.

The day ahead in the euro area and US

After the ECB today put the ball in the court of the euro area's fiscal authorities to provide meaningful stimulus, attention tomorrow should be on the European Commission and member states for any evidence of a workable plan. Data-wise, the end of the week will bring just final inflation figures from Germany, France and Spain. These are expected to align with the flash estimates that showed headline inflation rising 0.1ppt in Germany to 1.7%Y/Y, falling by the same magnitude in France to 1.6%Y/Y and declining by 0.2ppt in Spain to 0.9%Y/Y.

In the US, Friday will bring the University of Michigan consumer sentiment survey for March, which seems bound to suggest a drop in confidence as the coronavirus spread in the US. Indeed, while February's headline consumer confidence index rose to its second-highest reading since the early 2000s, the survey flagged some growing concerns in the latter responses and global equity markets have subsequently plummeted. Tomorrow will also bring import and export price indices for February.

UK

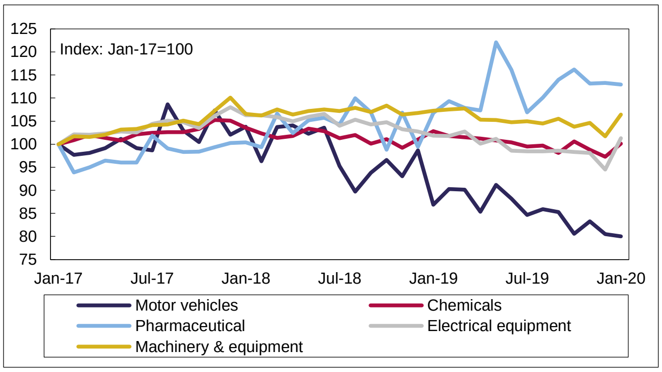
Housing market was on firmer footing before the virus hit

After yesterday's spurt of policymaking, today was far quieter for UK economic news. Data-wise, however, the latest RICS survey added to evidence that, before the coronavirus hit, the housing market was enjoying something of a renaissance. In particular, the survey's headline price index rose 11pts in February to a net balance of +29%, suggesting the strongest price growth in almost six years. And prices were reportedly rising across the UK, with London among those regions showing the greatest vigour. The survey also reported a significant increase in buyer enquiries and new selling instructions, and significant optimism about the sales and price outlook for the remainder of the year. Of course, until the coronavirus recedes, however, those hopes will now be dashed and activity in the market seems likely to shrivel.

The day ahead in the UK

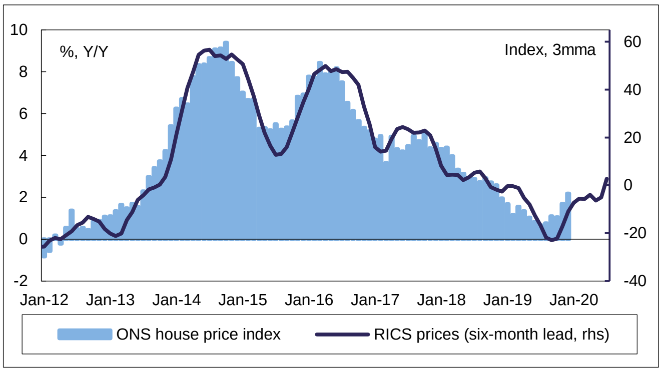
It should be a quiet end to the week for UK economic news with no data of note scheduled for release.

Euro area: Industrial production by good type



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: House price indicators



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Industrial production M/M% (Y/Y%)	Jan	**2.3 (-1.9)**	2.0 (-2.5)	-2.1 (-4.1)	**-1.8 (-3.6)**
	ECB main refinancing rate %	Mar	**0.00**	0.00	0.00	-
	ECB marginal lending rate %	Mar	**0.25**	0.25	0.25	-
	ECB deposit facility rate %	Mar	**-0.50**	-0.60	-0.50	-
UK	RICS house price balance %	Feb	**29**	20	17	**18**

Auctions

Country	Auction
Italy	sold €3.5bn of 0.6% 2023 bonds at an average yield of 0.74%
	sold€795mn of 0.85% 2027 bonds at an average yield of 0.92%
	sold€1.2bn of 1.35% 2030 bonds at an average yield of 1.29%
	sold €1.5bn of 3.1% 2040 bonds at an average yield of 1.97%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	GMT	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	07.00	Final CPI (EU-harmonised CPI) Y/Y%	Feb	1.7 (1.7)	1.7 (1.6)
France	07.45	Final CPI (EU-harmonised CPI) Y/Y%	Feb	1.4 (1.6)	1.5 (1.7)
Spain	08.00	Final CPI (EU-harmonised CPI) Y/Y%	Feb	0.8 (0.9)	1.1 (1.1)

Auctions and events

Country	GMT	Auction / Event
		- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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